SUMMARY OF UTS DECISION AND RELATED MATTERS

Summary of UTS Final Decision

Following its consideration of industry submissions, the Electricity Authority has confirmed today its draft decision that the events leading to wholesale electricity spot market prices of around $20,000/MWh on Saturday, 26 March 2011 were an undesirable trading situation (UTS).

As discussed in the draft decision released by the Authority on 6 May 2011, the UTS arose from several factors combining to create the undesirable situation that the wholesale market for electricity was squeezed.[1] This resulted in an exceptional and unforeseen circumstance that threatened, or may have threatened, generally accepted principles of trading and the public interest. As a result, in the opinion of the Authority, if interim prices for the relevant trading periods were left unchanged, the events on 26 March threatened, or may have threatened, trading on the wholesale market for electricity and would, or would be likely to, have precluded the maintenance of orderly trading or proper settlement of trades.

The Authority proposes to reset Huntly power station offer prices for trading periods 22 to 35 on 26 March at $3,000/MWh. This revision to the offer prices is intended to reflect the prices wholesale electricity market purchasers would have incurred with their own demand response or would have paid for demand-side response, had they received continuing forecasts of exceptionally high prices in the hours leading up to the UTS.

Further details on the UTS decision

The Authority's final decision that a UTS occurred is based on the facts that:

(a) Genesis Energy's offer prices at its Huntly power station set exceptionally high prices in the wholesale electricity spot market; and

(b) parties exposed to those spot prices had good reason to believe Genesis Energy's offer prices would not translate into spot market prices, until it was too late for them to take any action to avoid paying those prices.

Had electricity consumers been aware of the exceptionally high prices in advance, they would have, in many instances, reduced demand or secured other sources of generation, as occurred on Saturday, 2 April 2011, at the prospect of a repeat of the exceptionally high prices of 26 March.

Although Genesis Energy submitted its $19-20,000/MWh offers to the market on Friday, 25 March 2011, forecasts of spot market prices failed to consistently predict actual prices, due to demand forecast inaccuracies in the price forecasting process. While $20,000/MWh prices were forecast at 2pm and 2:30pm on 25 March, price forecasts fell to approximately $150/MWh later in the afternoon of 25 March in response to Mighty River Power's decision to offer an additional 125MW at its Southdown power station. Thereafter, there was no indication of the forthcoming exceptionally high prices on 26 March until almost real time, even though the transmission constraint caused by the transmission network outages was shown to be binding in the price forecasts.

In addition to the demand forecast inaccuracies, Contact Energy's decision to withdraw 425MW from its Stratford power stations at around 1pm on 25 March, along with revisions to transmission network constraint limits by the system operator during the transmission network outages on 26 March, also contributed to Huntly power station offers translating into exceptionally high spot market prices.

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[1] A market squeeze occurs when a generator is in a position whereby it is able to "name its price" but parties exposed to that price are unaware of the price until it is too late for them to curtail their demand or increase their own generation or arrange for someone else to undertake these activities for them.

Considering all the factors together the Authority's final decision is that the events of 26 March constituted a UTS.

UTS claimants also alleged that Genesis Energy may have materially breached the law, engaged in manipulative or attempted manipulative trading activity, and engaged in conduct in relation to trading that was misleading or deceptive, or likely to mislead or deceive. The Authority's final decision is that these allegations are not substantiated.

Further consultation on proposed remedy

The Authority is consulting interested parties about its proposed remedial actions to the events of 26 March, and expects to make a final decision on these actions around the end of June. Accordingly, the Authority will not discuss or comment on any aspect of the proposed remedial actions pending its final decision on them.

This additional round of consultation is required because the first consultation was on the Authority's draft decision. Having now reached a final decision that the events of 26 March constitute a UTS, the Electricity Industry Participation Code (the Code) requires the Authority to consult affected participants regarding any actions it intends to take to correct a UTS.

RELATED MATTERS

Implications for the spot market

The Authority has considered the possibility that resetting offer prices for 26 March may be viewed by some participants as imposing a price cap on generator offers in the spot market. The Authority emphasises that its proposed actions in regard to price-setting are specific to the events of 26 March. The Authority also points out in its decision that, had the exceptionally high prices resulted from a genuine scarcity of electricity supply, and had the high offer prices been well signalled in advance, it is unlikely the Authority would have found the events of 26 March constituted a UTS, as it is important price is used to signal scarcity to industry participants.

Similarly, if a generator is in position where it can "name its price" even though there is no genuine scarcity of electricity capacity or supply, then it is unlikely the Authority would declare a UTS – regardless of the resulting spot market price – provided the likelihood of those prices had been signalled sufficiently in advance that other parties were able to respond by curtailing their demand or increasing their own generation or organising other parties willing to take those actions.

Under this approach a generator may set its offer prices above its underlying costs without risking the Authority finding a UTS, but doing so risks encouraging longer-term competitive responses by parties exposed to spot market prices, such as investment in demand-response capability or standby generation, or hedging with other parties that can supply those services. In contrast, these investment and hedging incentives do not arise from a market squeeze, as participants are unable to respond to the high prices arising from the squeeze.

Consistent with the Authority's proposed remedy for the UTS on 26 March, when there is not a genuine scarcity of supply a generator in a position to name its own price risks the Authority finding a UTS if it is possible parties will have insufficient time to take actions to curtail their demand or increase their own generation *and* it sets its offer prices without regard to the cost other parties would incur if they had the opportunity to curtail demand or increase their own generation.

Implications for the hedge market

In regard to the hedge market, the Authority believes the draft final prices provide an incentive for parties to manage their risk that is consistent with the incentive they would face in a workably competitive market. In contrast, the interim prices for 26 March would undermine the hedge market as such prices reflected a market squeeze rather than a workably competitive market. Hedge markets thrive when participants are confident the underlying physical market is competitive, and they are hampered when this is not the case.

Market performance report

The Authority has decided not to proceed with a market performance report regarding the events of 26 March, as the UTS decision document already contains detailed analysis of the event. Moreover, the Authority's work programme already contains several pro-competition and pro-hedging initiatives for addition to the Code by the end of the year. The Authority believes that, had these measures been in place, the exceptional events on 26 March would not likely have happened. The Authority has decided to concentrate its efforts on developing these initiatives as expeditiously as possible, given the need and requirement for full consultation with stakeholders about such changes before any final decisions are made.

Details on the Authority's work programme are on its webpage http://www.ea.govt.nz/our-work/programmes/.